RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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February 15, DJIA 9903.14; PTI 5318; A-D Ratio +.40
February 22, DJIA 9968.15; PTI 5320; A-D Ratio +.30
March 1, DJIA 10368.86; PTI 5330; A-D Ratio +1.36
Dow Yield: 1.76% Dow p/e: 28.03
Gold 50-day MA: 288

THE PICTURE — The essence of Dow Theory is that stocks make extended (multi-year) moves from extreme undervaluations to extreme overvaluations and then back to extreme undervaluations. The extended movements we term bull markets and bear markets. In the "old days" we used to call these yield cycles.

Looking back over history, these major moves are the only sure phenomena in the stock market. The problem, of course, is how to judge when stocks are extremely undervalued and when stocks are extremely overvalued. This value question is the reason why Charles H. Dow and all the Dow Theorists who followed him placed such great emphasis on buying stocks when stocks represented great values, and selling stocks when those stocks become overvalued.

WILSHIRE 5000: I am indebted to a subscriber who just e-mailed me the following critical study. The Wilshire 5000 is the best measure of the entire US stock market.

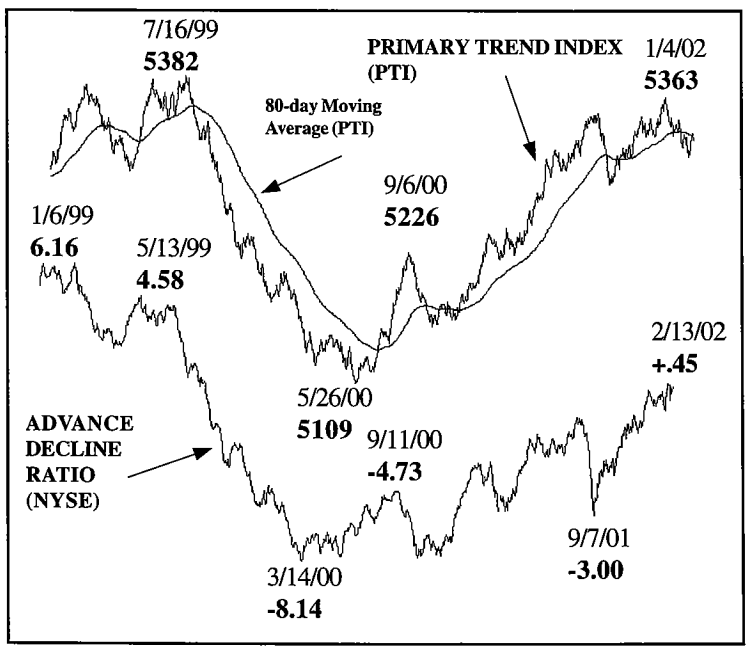
The Wilshire actually contains about 6,500 stocks. The all-time high for the Wilshire was set on March 24, 2000, at 14,751.64. The Wilshire closed on Friday, February 22, 2002 at 10,249.32. That translates into a loss of about $4.5 trillion from the all-time high. A lot of money has clearly gone up in smoke.

The total market value of the Wilshire Index (and therefore the US stock market) on January 31, 2002 was $12.7 trillion. That makes the stock market valued at about 129% of GDP (GDP being $9.9 trillion).

At the March 2000 highs, the ratio reached an unbelievable all-time high of 170.8%. The higher the ratio, obviously the more overvalued the stock market.

According to *Ned Davis Research* (800 241 0621), the norm of this ratio since 1925 has been **54.5% of GDP**. Ned Davis also indicates that **above** 71.8% is the "very overvalued" area.

To place things in perspective, here are the pre-crash high ratios.



Pre 1929 crash = 86.5% (Dow fell 89% in three years).
Pre 1973-74 crash= 79.2% (Dow fell 45% in two years).

The US stock market remains "very overvalued" at a current 129% of GDP.

The bull market started in 1982 and ran to 2000 — 18 years of higher and higher prices.
In 1982 at the beginning of the bull market the ratio was 36%. We have run from 36% of GDP to 170% of GDP.

Russell Comment: This is as fundamental a study as you can find. It tells us that this bear market still has a long way to go. How this bear market takes stocks back to the point where they represent great values is the big question. How it gets there, what has to happen, how investors' perceptions will change, how price/earnings will decline — all this is the great mystery and adventure that lies before us.

One argument runs that the stock market can remain in this area while earnings move up and catch up. Then somewhere ahead earnings will advance to the point where stocks (still in the area under say DJI 11,700) will appear to be bargains again. This may take as long as a decade, but well, we'll wait.

Another argument states that this will ultimately evolve into an old-fashioned costly bear market with stocks finally on the bargain table. It's only a matter of time.

One comment I want to make is that an entire generation (1980 to 2000) has grown up watching stocks climb higher. In the '90s, the public began to believe that stocks would generate gains of 20% a year, that dividends were unnecessary and a waste of assets, that price/earnings of 25 to 50 were both justified and normal, and that all dips were buying opportunities.

During the latter part of the '90s, Wall Street's analysts and strategists (many of the same "bull market generation") accepted the same criteria. Furthermore, greed took over, and analysts started to recommend many of the same stocks that their employers had underwritten.

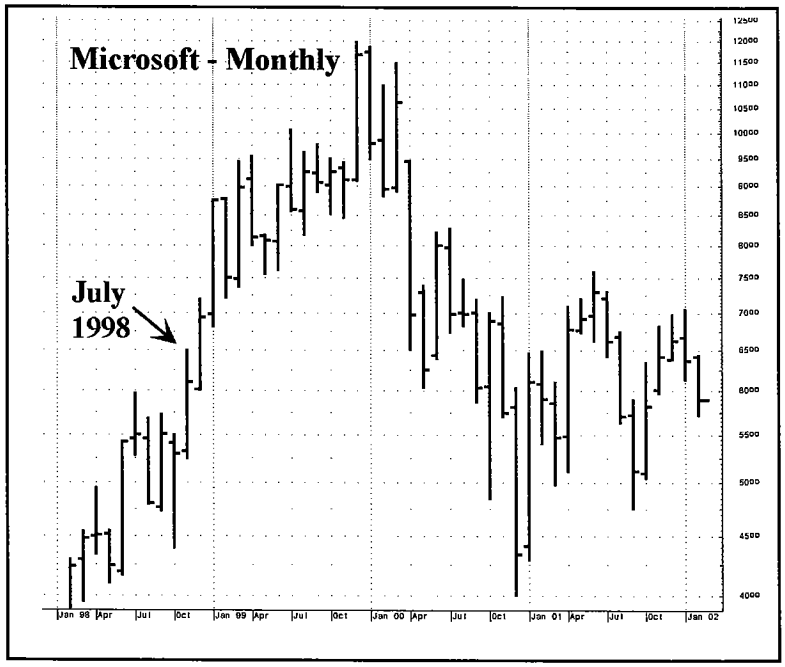
This ingrained bullishness is still a fact of life in the US investment scheme of things. Outrageous valuations are still accepted today. Stocks that have never paid a dividend are accepted today, stocks with pro forma or operating or questionable earnings continue to be accepted today.

What I believe is going to happen is that a long series of negative events will materialize. Slowly, the public's love affair with common stocks will change. In its place we'll see disappointment, frustration, anger and finally disgust. This **change in perceptions and psychology** will go to battering price/earning ratios down. People will begin to avoid stocks with P/Es in the 20s, 30, and 40s and beyond — and they'll avoid stocks with no dividends.

Since people will not be enjoying capital gains on their stocks, they will begin to demand dividends. From there, the bear market will accelerate its downward spiral. Debt will become anathema. The bear market will move deep into its second phase, and thence into its third and final phase.

Finally, that word will come to the fore. The word is **VALUES, GREAT VALUES,** and **VALUES.**

MICROSOFT: Dividends, anyone? Here's a monthly chart of a great growth stock, Microsoft. If you had bought MSFT four years ago in July 1998 at 59.80, you would be behind on price today and you would have never received a cent in dividends, this despite the fact that MSFT today has $38 billion in cash or equivalents.



NOTES & QUOTES — A subscriber writes to *Barron's* Thomas Donlan: "Could you explain how Treasury debt rose 135 billion in the fiscal year ending September 30, 2001, this while the budget surplus was 127 billion? Could you explain why the Treasury debt rose 400 billion in the last four years of budget surplus?"

And Donlan answers: "Treasury debt includes debt held by the Social Security trust fund. In a surplus year, we are not borrowing the money to run the government; we are issuing markers to Social Security. Treasury debt is issued to the trust fund (and other trust funds, such as government retirement, highway, airport, etc.) and the cash from Social Security and other dedicated taxes is spent on general government or used to redeem Treasury debt held by the public. Treasury debt previously issued to trust funds also earns interest, and the interest is paid in the form of more Treasury debt.

"On a unified basis, including all the trust funds, we have never run a surplus. Thomas G. Donlan."

Russell Comment: It's sad, it's pathetic, but this is how "they" run our government. On an honest basis, the government is still spending more than it takes in. It's all a matter of debt, debt, and more debt.

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Do you ever envy the life of celebrities? Want the cure? Read the *National Enquirer*. Here are some typical headlines from the February 19 issue:

"Nancy Reagan collapses, the tragic health secret she's hiding.
"Mariah Carey, Fat Farm Tortures."
"Jeb Bush, Caught in Illegal Drug Cover-Up Scandal."
"Another Dog Charity For Courteney Cox."
"NYPD Blue Beauty Boozing Out of Control."
"Wesley Snipes Hit With Love-Child Lawsuits."

And all the above in a single issue of the *Enquirer.* When people come to our house, they see the *Enquirer* and say, "You read that trash?" And then they promptly grab the paper and settle down to read it.

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How are the universities doing? Here are the latest figures on endowments (in billions of dollars). Harvard 18.3; Yale 10.7; Univ. of Texas 9.4; Princeton 8.4; Stanford 8.2; MIT 6.1; Univ. of Calif. 4.7l; Emory 4.3; Columbia 4.3; Texas A & M 4.0. Most except Harvard have lost money over the last couple years but still in great shape.

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Dirty Secret: Mutual fund companies pay $1 billion a year to large brokerage houses that sell their products. I'm not talking about the commission that is known as loads. I'm talking about payments the broker's firm receives from the fund companies over and above the commissions.

So if you buy load funds (which I don't recommend), find out whether the fund you buy is paying your broker's firm a "bonus" or stipend above the commission or load. That's the dirty little billion-dollar secret that's going on in the mutual fund business.

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What's the fastest growing religion in the US? Right, it's the Mormons. There were one million members of the Church of the Latter Day Saints in 1947. Today, worldwide, there are 11 million members, with the majority outside the US. One seventh live in Utah, but the capital of the State, Salt Lake City, is strangely only 50% Mormon. There are now 107 Mormon temples, 55 outside the US. But these temples are not where Mormons worship, they are encouraged to worship in local meeting houses. Non-Mormons can never see what goes on inside the temples. After construction of a temple is completed, visitors can tour the inside for a few days. But once a temple is dedicated, only card-carrying Mormons are admitted (and they do carry cards). The Mormon Church is well financed, and Mormons are encouraged to donate 10% of their income to the Church.

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An article from the March 4 issue of *Fortune* (great magazine) is entitled, "It's All Made in China Now." Excerpts – This historic transformation of the world's most populated country, from a maker of the Winnie the Pooh doll and Air Jordans to the world's high-tech foundry, could not be more apparent. A steady surge of foreign direct investment, unaffected, it seems, by global macroeconomic cycles, is recasting China's industrial base. And it is safe to say that the world, particularly Japan and the rest of Asia, will never be the same. . . . Drive through the now famous Pudong industrial zone in Shanghai, and you'll find spanking-new factories as far as the eye can see. . The implications? It means, first, that China's emergence as a reliable, stable producer of high-value, technologically sophisticated products will rewrite the economics of a wide range of manufacturing industries, not just those that are labor intensive (such as toys and textiles). In fact, that process is already well under way. For a global company, it simply means 'that you have to have a major manufacturing presence in China, because if your competition isn't there yet, they soon will be.' "

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Any money in bonds? There is for the man who is arguably the smartest man in the bond business, Bill Gross. Gross oversees more than $350 billion in bonds, including the huge Pimco funds. Pimco manages $250 billion in pension funds, private accounts and a stable of mutual funds led by Gross' flagship $50 billion Pimco Total Return fund. It also controls another $100 billion for its parent, the German insurer, Allianz.

Allianz (Munich based) paid $3.3 billion for Pimco in 2000, and Gross received $233 million for his shares, along with a five-year contract worth $40 million a year plus a regular salary and bonus.

It all reminds me of something my father told me back in the early '50s. "Dick," he said, "If you want to make money, go into the money business." Sounds like Bill Gross heard the same advice. Of course, to my mind, there's nothing more fascinating than the money business. It entails and takes in almost everything from pure mathematics to what the politicians are hatching up in Argentina.

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Have you noticed the concentration in the defense industry? It's come down to three huge suppliers, Lockheed Martin, Boeing and Raytheon. Now Northup Grumman is bidding to buy TRW.

A few second-tier suppliers have been merging, trying to get a piece of the huge defense-spending coming up. Honeywell and Allied Signal merged in 1999. United Tech. bought Sundstrand in 1999. General Dynamics bid for Newport News last year but lost to Northup Grumman. GE, maker of jet engines, tried to buy Honeywell but was thwarted by European anti-trust officials last year.

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From a column by Paul Craig Roberts – "The top 25% of the US income earners – 32 million people – pay 83% of the personal income taxes collected. The remaining 75% — nearly 100 million people – bear only 17% of the income tax burden. Seventy million voters have no tax liability whatsoever.

"Not only do a majority of Americans collect more in government handouts than they pay for in taxes, but 43% of those who file income tax returns make money on the income tax, as they can get refundable credits in excess of their tax liabilities.

"The stark facts are these. There are about 167 million voters with little or no income tax liabilities and 32 million voters burdened with 83% of the income tax bill.Outvoted 5-to-1, these 32 million are confined to tax slavery. They are ruthlessly exploited, and immigration is worsening their prospects."

Russell Comment: I often hear people say, "Hey, consider yourself lucky that you make enough so that you can pay taxes." Why doesn't that make me feel better? I'm a firm believer in the tax on sales. You buy more, you pay more taxes. A consumption tax would also put a curb on much of the mindless buy, buy, buying that goes on today.

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Money market funds are not insured as are savings bank deposits. In Japan there is so much worry about credit that the Japanese are buying three and six month Treasury bills that offer zero return. This is the first time large bids for these zero-returns have been seen. What's happening is that investors are fleeing common stocks and corporate bonds and moving to the safety of government paper, even though that paper pays nothing.

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Debt, debt, debt – California Governor Gray Davis projects a state deficit of around $12.5 billion. But Legislative analyst Elizabeth Hill has come up with a shocker. She says that the deficit will be $5 billion higher than the Davis estimate. Hill says that revenues are overstated by $3.9 billion and expenses are understated by $1.1 billion. Cute.

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If you live in New York, stop smiling. New York City and New York State are by far the largest debtors in the nation. The City has an astounding $42 billion in loans outstanding, and the State has $38 billion. No one else is even close – California has $25 billion. New York City and New York State each spend about $4 billion a year on debt payments. Want the good news – New York's new Mayor Bloomberg wants the city to borrow another $1.5 billion to help cover a $4.7 billion budget gap. That would mean selling bonds to cover day-to-day expenses, something the City hasn't done since the 1970s.

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Saudi Arabia has become a deepening problem. Its birth rate is one of the highest in the world. In 1980 Saudi Arabia had a population of 7 million. Today it's 19 million. Meanwhile, per capita oil income has fallen from $19,000 at the height of the oil boom in 1981 to about $7,300 today. With oil income down and not going to hold up bloated government employees and extended families, the Saudis have several million unemployed. A startling figure – 40% of the Saudi population is now under 14.

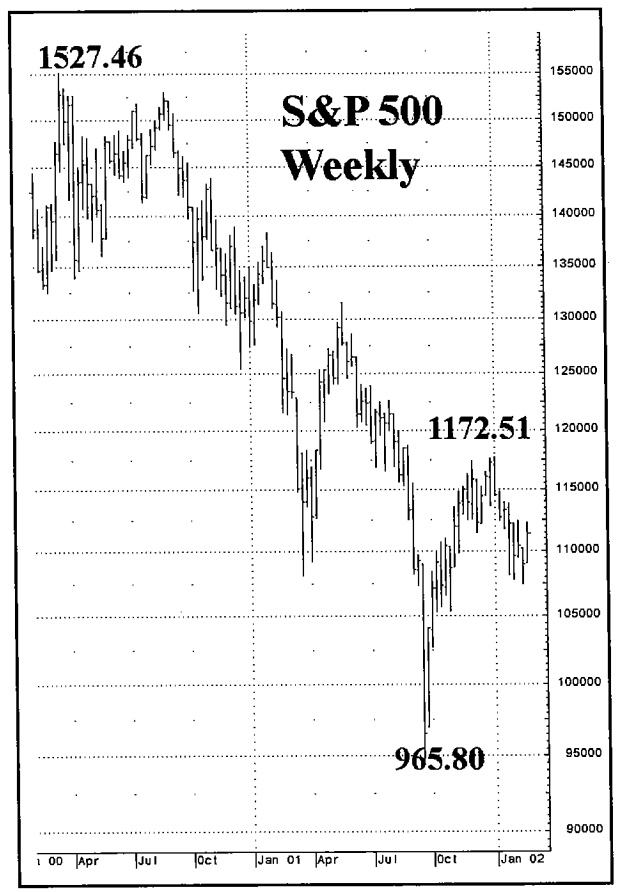
INVESTMENT POSITION: This is going to be a marathon bear market, not a sprint. Therefore, I believe that subscribers should be thinking in terms of years, rather than weeks or months.

A few years back, when the bear market first started, I wrote that I thought this bear market could be very much like the 1966 to 1974 bear market; in other words a series of mini-bull and mini-bear market swings ending with a wipe out as per 1973-74. We could now be in the first mini-bull sector of what promises to be an extended bear market.

This is the problem or should I call it a choice? Should we "play" each stage of the bear market – buy the upswings (as now) and sell the bear declines? My personal opinion is that most subscribers will not be agile enough to play the many swings which may accompany this bear market.

OK, what's the alternative? The alternative is to compound, which means having a steady source of income and then reinvesting that income in the safest dividend-paying stocks that you can find. My own choice, made a few years back, was to buy top-grade municipal bonds, and then to reinvest the incoming interest in top-grade dividend-paying utilities. So far this strategy has worked well. My account has been up every quarter. This is what I'll keep doing. You may have a better system. If you do, my advice is to stay with it.

LATE NOTES: This is a weekly chart of the S&P 500. Please study the following carefully, because this chart is telling a critical story. The first thing we see on this chart is the bull market top for the S&P, a final top which occurred on March 24, 2000 at 1527.46.



Next, we see the initial bear market decline, a decline which took the S&P down to a low of 965.80 on September 21, 2001. From there, the market rallied, taking the S&P up to high of 1172.51 on January 4, 2002. That high of 1172.51 has, so far, been the recovery peak for the S&P. Following the 1172.51 peak, the S&P sold off again to a February 7th 1080.17 low — then rallied. And that's where we are now.

The S&P rally off the September 21 bear market low has been much weaker than the Dow rally off the same low. In fact, measuring from the September 21 low to the recent January 4 high, the S&P has, so far, retraced only 35% of the ground lost on the initial bear market down-leg.

With the Dow so much stronger than the broad S&P 500, I have to wonder just what we are dealing with. Will this advance evolve into a true mini-bull market, or will the reluctant S&P halt the Dow's advance (remember, the Nasdaq is even weaker than the S&P)? That's the fascinating question we are facing at this time.

What's the answer? I've been skeptical of the rise off the September 21 low, but what do I know? Let the market tell its story in its own good time. There's an obvious major divergence between the Dow and the other two major averages. The market will give us its answer, probably over the next few months.

NEXT MAILING: March 27, 2002